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The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

September 15, 2021

Marc Sauvé
Senior Manager, Actuarial
Private Pension Plans Division
Office of the Superintendent of Financial Institutions Canada
Kent Square 255 Albert Street, 12th Floor
Ottawa, ON, K1A 0H2
Via email: marc.sauve@osfi-bsif.gc.ca

Re: Draft comments on OSFI's proposals on replicating portfolios

Dear Mr. Sauvé:

ACPM is the leading advocacy organization for plan sponsors and administrators in the pursuit of a balanced, effective and sustainable retirement income system in Canada. We represent plan sponsors, administrators and trustees and our membership represents retirement income plans that cover millions of plan members.

ACPM appreciates the opportunity to comment on OSFI's Revised Section 2.7.4 of the Instruction Guide for the Preparation of Actuarial Reports for Defined Benefit Pension Plans – Draft (the "Draft Guide"). Our initial comments on the draft guide issued in December 2019 were contained in our response of March 19, 2020 and included several reservations about the Replicating Portfolio guidance. We are pleased that the consultation has resulted in significant changes in the Draft Guide, reflective of the thrust of our comments. Our comments on this version work within the framework established in the Draft Guide, focusing on specific points.

Funding Symmetry and Margins

Our comments on the 2019 draft underlined how, for some time, many DB pension plan sponsors have expressed concerns that the environment of historically low interest rates presents a very challenging time. Solvency funding requirements have become an onerous burden on employers, many other Canadian pension jurisdictions have recognized this point and have enacted helpful legislation. In addition to plan termination being unlikely for the vast majority of pension plans being funded using replicating portfolio methods, the Draft Guide requires the inclusion of margins. By definition, these margins cause pension plans to be overfunded, illustrating the need to address funding asymmetry.

OSFI notes that some of the comments that were received in the consultation on the 2019 draft related to this problem. Though current legislation does not fall under OSFI's purview, consultation on Solvency Reserve Accounts (SRAs) are underway. We continue to encourage that, until the sustainability review is completed and funding asymmetry addressed, the proposed changes to the replicating portfolio method be deferred as they are likely to increase solvency funding.

Required Confidence Level

The Draft Guide proposes to establish provisions for adverse deviations determined at confidence levels that vary between 85% and 99.5% based on credit rating.

According to a January 2021 Moody's default study, the risk of default over 5 years is 0.19% for a AA-rated bond and 0.88% for a Baa-rated bond. Combined with the proposed confidence levels of 85% and 90% respectively, the risk of loss for plan members is less than 0.10% for investment grade bonds, which is extremely secure. We believe that the confidence levels could be relaxed for investment grade ratings.

Using a confidence level of 75% for AA-rated bonds would result in a risk of loss of 0.05% over 5 years, while using a confidence level of 85% for BBB-rated bonds would result in a risk of loss of 0.13% over 5 years.

Therefore, we suggest revising the various confidence levels shown on page 4 of the Draft Guide to 75/80/85/90/92.5%/97.5%.

Even though the plan's liquidation period might not be equal to 5 years, the revised confidence levels, combined with the respective risks of default, would produce a combined measure of benefit security between 99.4% and 99.9%, which can be considered as secure as insured annuities.

Also, we note that OSFI considers that a confidence level of 99.5% is equivalent to the security provided by an insurance company. We would like some background on how OSFI made such an assessment and whether the time horizon between the capital requirements of insurance companies and the pension funding requirements proposed in the Guide are aligned. Replicating portfolio models evaluate the risk of loss over the lifetime of a pension plan. Imposing security margins originally determined over a shorter horizon for the insurance industry would unduly inflate funding requirements for pension plans using the replicating portfolio.

Credit Ratings

In the revised guidance on economic risks, ACPM is pleased to see the use of employer credit ratings as a generally practical indicator of the financial support that may be available in determining the required confidence level. However, we question the choice of subordinated debt as the reference rating for the following reasons.

First, given that pension deficits would only go unpaid in a scenario where the corporation fails more generally (i.e., in an insolvency scenario), it seems more appropriate that the general corporate credit rating of the employer be used.

Second, subordinated debt ratings are typically set, at least in part, in reference to the specific terms of the subordinated debt (like timing and quantum outstanding) and may not be the best reflection of the corporations' ability to pay the pension deficit.

Third, on a practical level, many companies do not have rated subordinated debt but otherwise have a general corporate credit rating.

We also note that OSFI has not provided guidance where the employer does not have a credit rating. This could be the case because another member of the group of companies of which the “employer” is a member has a rating, or the employer is simply not rated by recognized rating agencies in Canada. We would suggest in such a case that the administrator be entitled to determine the level of employer support it can reasonably expect and to direct the actuary to use the appropriate corresponding confidence level.

Thresholds for using a Replicating Portfolio

The Draft Guide rightly restricts the use of alternative settlement methods to plans limited by the capacity of the Canadian annuity market. The establishment of a replicating portfolio and assumption of a series of annuity purchases are two separate alternative settlement approaches identified in the Canadian Institute of Actuaries (CIA) Educational Note on Alternative Settlement Methods for Hypothetical Wind-Up and Solvency Valuations. ACPM believes that the CIA Guidance should be relied upon in determining the applicable capacity thresholds. However, footnote 6 of the Draft Guide inappropriately inflates the CIA thresholds by a factor of five, by combining the capacity threshold with a series of annuity purchases over five years. It is unlikely that a Plan could purchase annuities at the capacity constraint limits for five years in a row, hence the necessity to break the settlement down into a series of purchases (i.e., five purchases of one-fifth the size). A plan reaching the capacity constraints published by the CIA should have the option of assuming either a series of smaller annuity purchases or establishing a replicating portfolio. The CIA has recently increased the thresholds. Continuing to apply a factor of five would exacerbate the overstatement.

Margin for Longevity Risk

The Draft Guide specifies a particular set of adjustments to the best-estimate mortality assumption (specifically, a 10% reduction in the base rates, and a 75% increase in assumed future improvements), and states that these adjustments will be assumed to correspond to a 99.5% confidence level for this risk. By specifying the confidence level corresponding to these adjustments, OSFI is setting a particular value on the variability of mortality. In reality, we would expect that such variability might vary considerably from plan to plan, depending on various characteristics, making it unlikely that the required adjustments would result in a 99.5% confidence level in the case of any particular plan. We would be interested in more information regarding OSFI’s rationale for the adjustments of 10% and 75%, and the link between these and the 99.5% confidence level.

Due to OSFI’s requirements, plans making use of a solvency replicating portfolio tend to be quite large, and would therefore be expected to be able to set their mortality base rates with a higher degree of credibility than smaller plans (often based on plan-specific experience studies). In such cases, a 10% reduction in the base rates may be excessive.

Even larger plans do not generally derive their own, plan-specific mortality improvement scales. The future of longevity improvement is highly uncertain and involves a great deal of actuarial judgment. In particular, the long-term effects of COVID-19 on longevity (if any) are unknowable at present. For these reasons, while we agree with including a margin for the risk of understating these improvements, we believe a lower adjustment would be appropriate.

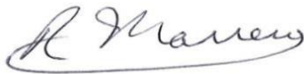
For plans that have reduced or eliminated their longevity risk through the use of longevity swaps or similar contracts, the corresponding margin should be reduced or eliminated accordingly, depending on the type and level of risk covered by the contract. For plans with annuity buy-in contracts, the portion of the liability related to the buy-in is not covered by the replicating portfolio, so no corresponding margin is required.

Correlation Between Economic and Non-Economic Risks

We appreciate that the Draft Guide now permits an adjustment to the total margin, to recognize that economic risks and non-economic risks are not perfectly correlated. In fact, we believe that these two classes of risks are very weakly correlated, if at all. For this reason, we believe that the minimum correlation assumption of 50% required by the Draft Guide is far too high. Any such correlation is likely much closer to 0% than to 50%, and we believe that this assumption should be left to the judgment of the actuary.

Thank you for the opportunity to comment on the changes to the Draft Guide. We appreciate that our proposals may require further discussion and please feel free to contact us if we can be of further assistance.

Sincerely,



Ric Marrero
Chief Executive Officer
ACPM